Growing Appetite for Dim Sum Bonds – The Global Rise of the Renminbi

caplaw.ch/2015/growing-appetite-for-dim-sum-bonds-the-global-rise-of-the-renminbi/

Daniel Heiniger

As the free flow of funds in and out of China is still regulated by the Chinese government, the Chinese financial market is basically closed to foreign investors. Although there are visible steps towards opening China's tightly controlled capital markets, the length of time it will take for China to fully open up its financial system can only be estimated. In the meantime, participants in global financial markets will increasingly focus on the development of the country's offshore renminbi market. This article gives an overview of the offshore renminbi denominated bonds at the center of China's master plan to internationalize its currency.

By Daniel Heiniger (Reference: CapLaw-2015-2)

1) Introduction

By the end of 2013, the Chinese currency, officially called renminbi (literally 'the people's currency'; RMB) had risen to become the second most-used trade financing currency in the world. In November 2014, the RMB entered the top five of world payment currencies, and now takes position behind the Japanese Yen, British pound, Euro and US dollar. These developments are results of the long-awaited steps taken by the Chinese government and domestic regulators in the last few years to liberalize the RMB. Consequently, different offshore RMB currency trading centers have emerged across the globe in financial centers such as Hong Kong, Tokyo, London, and New York. As outlined in a separate chapter of the twelfth five-year plan of the Chinese Government (China's Twelfth Five-Year Plan 2011-2015, Chapter 57), Hong Kong is playing an especially crucial part in supporting and assisting the rapid global development of the "redback", particularly through the development of an offshore RMB market.

As part of a multilayered strategy being employed by the Chinese government, the offshore RMB market has been established to (i) internationalize the RMB such that it can become a global reserve currency, (ii) smoothly control the cross-border capital flow while keeping the inflation in mainland China in check and (iii) develop an offshore RMB bond market.

2) The Young History of the Dim Sum Bond Market

In July 2007, after the publication of the 'Interim Measures for the Administration of the Issuance of RMB Bonds in Hong Kong by Onshore Financial Institutions' by the National Development and Reform Committee (NDRC), China Development Bank, one of the three policy banks in China, issued the first dim sum bond in Hong Kong.

In 2010, NDRC issued the 'Elucidation of Supervisory Principles and Operational Agreements Regarding Renminbi Business in Hong Kong' and signed a 'Supplemental Memorandum of Cooperation' with the Monetary Authority of Hong Kong. As a consequence of this expansion of the dim sum bond issuer pool by the Chinese government, multinational corporations such as McDonald's (RMB 200mn issuance) and Caterpillar (RMB 1 billion issuance) entered the market.

In October 2011, market restrictions were once again relaxed when the People's Bank of China (PBoC) and the Ministry of Commerce (MOFCOM) issued new rules governing the investment in China with offshore RMB funds (MOFCOM Announcement No. 87 of 2013 on Issues Concerning Cross-border RMB Direct Investment, http://english.mofcom.gov.cn). The new regulations have facilitated the repatriation of proceeds to the mainland.

During the last two years, there has been evidence that more diversified issuers entered the market and that locations other than Hong Kong, such as Singapore and London, became more active in the market (see also section 5 below). The issuance of dim sum bonds reached new record highs with a total issuance amount of RMB 371 billion in 2013 and RMB 587 billion in 2014 (HSBC, 'The A to Z of the RMB', Week in China 2014, data includes both RMB bonds and certificates of deposit).

3) Dim Sum Bond Characteristics

Although the conventional terms are not used in a consistent way in the dim sum bond market, a distinction should be made between **certificates of deposit** (CD) and bonds. CDs normally have a shorter tenor than bonds, with maturities ranging from one month to five years. The short duration makes them popular with issuers like Chinese banks. In 2013, approximately 70% of the total issuance of dim sum bonds was CDs. However, according to HSBC, it is likely that the share of bonds will increase up to 40% in the near future, but CDs will remain the favorite type (ZHAO, 'The A to Z of the RMB', Week in China, 2014).

Dim sum bonds with **fixed-rate coupons** are the overwhelming majority, accounting for over 95% of all issuances and the total amount issued between 2007 and 2014. The average coupon of the dim sum bonds issuances between 2011 and 2014 amounts to 4.1%. A major part of the investor base of the nascent dim sum market are buy-and-hold investors, who welcome the fixed-rate bonds to exclude interest rate risk if they hold the bonds to maturity. Less than 5% of dim sum bond issuances between 2007 and 2012 have been bonds with floating interest rate or zero-coupon bonds (FUNG, KO, YAU, 'The Offshore Renminbi (RMB) Denominated Bonds', 2014).

Over 90% of the dim sum bonds have a **short tenor** of one to three years (ASIFMA RMB Roadmap 2014). The prevalence of shorter maturities can be explained so far by the risk-averse investors who invest in dim sum bonds as a one-way bet on the RMB appreciation against the U.S. Dollar. This mindset guiding investor demand has hindered the development of a nascent fixed-income market so far because the yield curve is only represented by bond issues with short maturities.

However, the model in which new dim sum bond issuances will falter when the Chinese currency falls appears to have been broken: during the first four months of 2014, companies raised approximately USD 10 billion in dim sum bonds in Hong Kong and Taiwan even though the RMB was falling to its lowest point against the dollar in more than one year. This is double the amount during the same period in 2013. Some of these activities have been driven by refinancing needs when a spate of two- and three-years bonds raised in 2011 and 2012 came to maturity, but the broader market has been solid.

Prior to 2012, with the high expectation of RMB appreciation and a less diversified investor base, dim sum bonds were issued unrated and '**covenant-lite**' and were less investor-friendly compared to other debt instruments, e.g. synthetic bonds. Since more institutional investors have entered the market and RMB appreciation has lost its allure, investors are now focused more on bond protection and credit risk.

While covenants of dim sum bonds have been changing to align with those of synthetic bonds, e.g. (i) negative pledges preventing the issuer from using any of its assets for other debt obligations, (ii) more restrictions on future borrowings, (iii) cross-default clauses tying the issuing offshore subsidiary back to the cash-flow generating entity and (iv) fixed-charge coverage becoming more standard, dim sum bond documents still have limited operational disclosure beyond the financial statements of the issuing entity (FITCH, Dim Sum Bonds Pose a Paradox for Investors, 13 March 2012).

In terms of independent **credit rating**, less than 20% of the issued dim sum bonds between 2007 and 2012 had an international rating. However, issuers are increasingly aware that independent credit ratings by one of the three big rating agencies may help allay investor concerns. Since the investors are more focused on credit risks, rated dim sum bonds are becoming more and more standard.

Although dim sum bond investors normally hold their bonds until maturity and trading on the secondary market is rare, some dim sum bonds (130 out of 800 issues between 2007 and 2012) are **listed on exchanges globally** to attract investors who prefer disclosure requirements and monitoring from exchanges. While Singapore and Hong Kong have the most listings of dim sum bonds, Luxembourg, London and Frankfurt are also popular with issuers to attract more European investors. At the end of June 2014, SIX Swiss Exchange Ltd. became another platform for dim sum bonds when it announced the listing of its first RMB denominated bond issued by China Construction Bank.

4) Motivation for Issuers and Investors

There are several reasons for issuers raising funds in the dim sum bond market. Since Chinese companies can get access to both offshore RMB denominated (CNH exchange rate) and mainland (CNY exchange rate) market by issuing dim sum bonds and ‘panda bonds’ (bonds issued in mainland china) respectively, they can take advantage of the resulting opportunities for cross-border arbitrage.

Further reasons to raise funds in the dim sum bond market could include hedging RMB operating expenses as well as lowering the cost of borrowing compared to the higher cost on the Chinese mainland market. Finally, RMB appreciation potential and increasing demand of global investors who look for diversification of their investment portfolio can further encourage issuers to tap into the dim sum bond market.

Order books indicate that more than 50% of the investors in dim sum bonds were either commercial banks or private banks between 2007 and 2012. Another third are funds and asset managers. In terms of geography, the major holders of dim sum bonds are investors based in Asia, since Hong Kong and Singapore are the key CNH markets and major sources of offshore RMB liquidity.

In a recent survey by the Economist, 200 senior executives at institutional investors (split equally between firms headquartered in mainland China and those based elsewhere) were asked why they were gaining exposure in the dim sum bond market; the main reasons mentioned were currency appreciation and yields (The Economist, ‘Renminbi rising, Onshore and offshore perspectives on Chinese financial liberalization’, 2014). A 2.7% appreciation between end of 2012 and the start of 2014 and yields around 4% make the product an attractive proposition. Although investors realized in the first months of 2014 that RMB appreciation is not only a one-way story, participants expect that the trend of further RMB strength will continue over the next several years.

Additional reasons for investors to tap into the dim sum bond market are cross border arbitrage, market positioning and portfolio diversification.

5) The rise of RMB Offshore Centers Globally

With the appointments of the clearing banks for Frankfurt (Bank of China), London (China Construction Bank), Seoul (Bank of Communications), Paris (Bank of China) and Luxembourg (Industrial and Commercial Bank of China) by PBoC in the second half of 2014, it is becoming increasingly apparent that PBoC is seeking to accelerate the RMB internationalization process through the creation of a global network of offshore RMB clearing banks, currency swap agreements and related regulatory underpinnings that handle RMB transactions.

With regards to Europe, the continent is well positioned to play a major role for offshore RMB activities and in particular in the dim sum bond market. In terms of geography, Europe has a time zone advantage as a mid-point between Asia and North America and could act as connection point e.g. to the African market. With its highly developed financial centres, its investor pool and its historical trade ties with China, Europe has good arguments for becoming a center for RMB.

Further, new dim sum bond listings on exchanges in Luxembourg, London and Frankfurt earlier this year spurred competition between financial centers to be the Chinese currency’s European hub. Thereby, each centre is playing to its strengths in the development of RMB hubs.

The Swiss financial market, too, is well positioned to eat into the market share of RMB activities. After the signing of the free trade agreement between Switzerland and China in 2013 and its bilateral swap agreement of up to CHF 21 billion entered into by the countries in June 2014, state-owned China Construction Bank is expected to open a Swiss branch during 2015, following a deal to establish clearing arrangements in Switzerland for trading in RMB.

6) Opportunities and Challenges for the Dim Sum Bond Market

The recent development of the dim sum bond market offers new opportunities to domestic firms and foreign investors. Avoiding the regulatory red tape in mainland China by investing directly in offshore RMB bonds facilitates entrance into the RMB market. Further, the increase of CNH sources globally will further increase the demand for dim sum bonds. Based on the response to the recent issuances with dim sum bonds, most of which are highly oversubscribed, considerable interest is being shown in these products, especially from European investors. While the dim sum bond market has yet to mature and reach the critical mass to become an asset class in most international portfolios, it is already evident that portfolios including dim sum bonds benefit in terms of diversification.

However, the dim sum bond market will have to compete with the wider range of RMB investment options in the future. New offshore RMB channels for foreign investors sped up by the Chinese government such as the Renminbi Qualified Foreign Institutional Investor Program (RQFII) and the recent launch of the Shanghai Hong Kong Stock Connect will provide new access to Chinese stock and funds. The RQFII program enables funds from the offshore RMB markets to be invested in the domestic A-shares (shares listed on the mainland stock exchanges and available so far only for Chinese mainland investors), whereas the Shanghai Hong Kong Stock Connect will give foreign investors access to A-shares listed on Shanghai Stock Exchange through Hong Kong Stock Exchange as well as mainland Chinese investors access to H-shares listed on Hong Kong Stock Exchange.

7) Conclusion

The dim sum bond market, as the first offshore market for RMB-denominated capital assets, has experienced rapid growth during the last three years and will continue to play an essential role in the internationalization of the Chinese currency. The increasing use of RMB globally as trade and investment currency has made dim sum bonds an attractive option for investors as a way to profit, in particular from future appreciation and diversification. With the announcement of the individual swap agreements and clearing banks in European RMB offshore centers, Europe can play the lead role in accelerating the internationalization process of the currency. Given the efforts of the Chinese government to liberalize cross-border transactions and create the conditions for the RMB to become an international currency, it is reasonable to expect that the dim sum bond market will develop into a mature debt market with its primary focus in Asia.

Daniel Heiniger (daniel.heiniger@baerkarrer.ch)